



MEMORANDUM

To: Members of the Investment Committee
California Public Employees' Retirement System

Date: September 12, 2011

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Performance through June 30, 2011

PCA has received and reviewed Wilshire's Second Quarter 2011 Executive Summary of CalPERS' Investment Performance as it relates to the Real Estate Portfolio. The following items should be considered in your assessment of Real Estate's performance:

- In an illiquid asset class populated with multi-year partnerships, longer term results are more significant than those of a shorter duration.
- As previously articulated, the performance of the real estate portfolio has been hindered by three primary factors: i) the vintage-year concentration during the 2005 to 2007 period; ii) the high exposure to non-stabilized properties; and iii) high amounts of leverage employed at the peak of the cycle. These final two factors have exacerbated the recent underperformance to the benchmark as non-stabilized assets provide less income to insulate valuation declines and increased leverage magnifies returns in upward and downward market cycles.
- At the February 2011 Investment Committee meeting, the proposed Real Estate Strategic Plan was approved. This plan will provide for the implementation for the revised role of real estate as described in the recent asset allocation study. This role will be primarily to provide reliable current income and diversification from public and private equity return characteristics. Therefore, the portfolio will be shifted in emphasis over time towards strategic, stabilized, domestic core assets held for a longer term, and away from more tactical, opportunistic, appreciation-oriented investments held for a shorter term.
- Over the long-term, the real estate program has had poor results with a -23.9%, -12.0% and 1.8% return over the trailing three-, five- and ten-year periods, respectively.
- The total Real Estate Portfolio produced a 1.8% return during the quarter and a 10.2% return over the trailing year compared to the Policy Index returns of 3.8% and 19.9%, respectively.

- The Public REITs, which represent approximately 7% of the market value of the Real Estate Portfolio, had strong one-year performance turning in a 33.4% return, which matched the REIT benchmark, the FTSE EPRA NAREIT index.
- The Core Portfolio had strong quarterly and one-year performance with returns of 3.9% and 28.8%, respectively. The Core Portfolio was reappraised as of March 31, 2011 and had appreciation particularly in the Apartment and Retail programs. The March 31, 2011 appraisals captured the impact of cap rate compression across US real estate despite only spotty and moderate improvement in fundamentals.
- The Value-Added portfolio had poor returns for the most recent quarter with a -14.0% return. An appraisal has been conducted for the CalEast Solstice holding in the Value-Added portfolio which will be reflected in the next quarterly report. Based on preliminary estimations, it is expected to result in a write-up in value.
- The Opportunistic Portfolio turned in a 2.8% return for the current quarter which lagged its policy index which had a quarterly return of 4.4%. Over the longer-term the Opportunistic portfolio has had poor results with a -31.4%, -19.7% and -3.6% over the trailing three-, five- and ten-year periods.
- The market value of the Real Estate Portfolio as of June 30, 2011 was \$18.6 billion, which represents an increase of \$3.7 billion or 25% from last year (June 30, 2010). The overall increase in value in the Real Estate Portfolio is attributable primarily to appreciation recorded and new equity that has been funded for deleveraging assets.
- As of June 30, 2011 the real estate asset class represented 7.9% of the total CalPERS portfolio, below the target allocation of 10.0%. It is important to note that on August 15, 2011 the Investment Committee approved reducing the target to real estate to 8% through December 31, 2011.
- CalPERS Staff has been working on setting up new partnership agreements with strategic partners in the Base and Domestic Tactical Programs. Further, one partnership in the International Tactical program is also underway. These new partnerships would be part of the Strategic portfolio going forward.
- The Loan-To-Value (LTV) policy limit is no longer in breach for the total portfolio with a 48.9% LTV. In addition, the Core portfolio is now in compliance with its LTV limit of 45% with an LTV of 41.3%. Furthermore, the recourse debt component is within policy with a total of \$1.8 billion in total recourse debt. Over the past 12 months the overall LTV has fallen by nearly 10% and the recourse debt amount has fallen by \$1.1 billion.

We are available to take any questions of the Investment Committee.

Respectfully,



Paul Mouchakkaa

Managing Director